SENATE TAXATION
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NATIONAL ASSOCIATION OF
REAL ESTATE INVESTMENT TRUSTS®

WRITTEN TESTIMONY OF

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BEFORE THE MONTANA SENATE TAXATION COMMITTEE

HEARING ON S.B. 120

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Mr. Chairman and members of the Committee, the National Association of Real Estate Investment Trusts, Inc. ® (NAREIT), thanks you for this opportunity to testify in opposition to S.B 120, legislation that would eliminate the Montana dividends paid deduction (DPD) for all real estate investment trusts (REITs) contrary to federal tax rules and the existing laws of virtually every other state with an income-based tax system. NAREIT is the worldwide representative voice for U.S. REITs and U.S. publicly traded real estate companies. Members include traded and non-traded REITs and other businesses that own, operate, and finance income-producing real estate, as well as those firms and individuals who advise, study, and service those businesses.

In Montana, REITs have invested million of dollars in commercial real estate, employ many Montana residents and invest in subsidiary entities that pay millions of dollars in Montana taxes. The Montana real estate owned by REITs generates millions of dollars in property taxes. These taxes are on top of the individual income taxes currently generated by REIT dividends paid to Montana residents.

Background: REITs Are Not "Tax Shelters," But Were Designed to Benefit the "Small Investor." By way of background, Congress created REITs in 1960 to enable investors from all walks of life to own professionally managed, income-producing real estate through companies modeled after mutual funds. REITs combine the capital of many shareholders to invest in a diversified portfolio of income-producing real estate, such as apartments, hotels, shopping centers, offices, warehouses, and timberlands. REITs are required to annually distribute at least 90% of their taxable income to their shareholders. In exchange for doing so (and for satisfying a large number of other requirements to ensure that REITs remain real estate-focused), federal law grants REITs (and mutual funds) a dividends paid deduction ("DPD"). This places investors in approximately the same "after tax" position they would be in as if they had invested directly in the real estate. In 2006, publicly traded REITs distributed more than $15 billion to their shareholders.

REITs Benefit Investors and the Economy. Congress' vision has been realized: as of February 2007, nearly 200 publicly traded REITs had a total equity market capitalization of over $450 billion. Investors have benefited from owning REITs: the 35-year compound annual return for the period ending December 31, 2006 of the S&P 500 stock index was 11.35%, while that of REITs was 13.97%. The economy benefits from REITs as well. Because REITs cannot pass through losses to investors (unlike partnerships), their focus must be on investing in income producing properties and annually distributing that income to their shareholders. Furthermore, unlike other real estate owners that use high levels of debt, average debt levels for public REITs are around 50%, leading to less volatility in the real estate market and fewer bankruptcies and workouts. Over 20 countries currently have some form of REIT legislation in place that allows for a single level of taxation. In addition in December 2006, Italy introduced a REIT structure, and just this year, a "U.K. REIT" became possible.

Most States Tax REIT Income Only Once at the Shareholder Level. Currently every state but one with an income-based tax system (including Montana) allows the DPD for public REITs. As a result of the DPD, most, if not all, of a REIT's income is taxed at one level – the shareholder level. Montana thus benefits by taxing Montana residents investing in REITs that have no Montana operations. For example, two SEC-registered, non traded REITs that do no business in Montana distributed over $850,000 to Montana shareholders in 2005 and 2006, and these companies have seen their Montana shareholder base increase dramatically in the last few years.

We oppose S.B. 120 for the following reasons:

- S.B. 120 would enact a drastic policy change that would put Montana at odds with practically all other states regarding the taxation of REIT income at the shareholder level only based on the state of shareholder residence. Montana currently taxes all REIT dividend income received by Montana resident shareholders, regardless of where the REIT's real estate is located. All other states that impose income taxes also tax the REIT income based on the location of the resident that receives the REIT dividends, not based on the location of the real estate. S.B. 120 would shatter this comity of state taxation principles by unilaterally double taxing REITs (and their shareholders) that do business in Montana. In the past decade, a number of states such as Idaho, Kentucky, New Jersey, and North Carolina have examined, and then rejected, the disallowance of a REIT's DPD except in limited circumstances.

- S.B. 120 Would Make Montana Non-Competitive. Disallowing the DPD would make Montana virtually the only state to impose a double level state income tax on REITs and unlike other business entities such as partnerships, LLCs and S Corps, REITS would continue to be compelled by federal law to distribute at least 90% of their annual taxable income to shareholders. Although S.B. 120 would allow Montana REIT shareholders to exclude dividends from MT REITs, non-Montana REIT living resident in states with income taxes would face a new additional level of income tax on their dividends from REITs with Montana properties, potentially causing them to shun such investments. Most REITs investing in Montana have the overwhelming majority of their investments in states other than Montana, many of them could choose to sell their Montana properties or, at the least, not expand their Montana operations in the likely scenario that investments in other states would produce better after-tax returns for REIT shareholders.

- It Wrongly Assumes that REITs Operate Just Like Other Real Eestate Companies Without Recognizing the Stringent and Complex Asset, Income, Compliance and 90% Distribution Requirements Placed on REITs That Other Companies Need Not Satisfy. It is incorrect to believe that entities such partnerships, LLCs, and S corporations that may own real estate face the same limitations as do REITs.

- As a Practical Matter, Listed REITs Could Not Comply With S.B. 120. While S.B. 120 proposes to allow Montana resident shareholders in certain REITs that pay Montana taxes an exclusion from tax for dividends from these REITs, most listed REITs cannot ascertain the residency of their shareholders and could not inform their shareholders easily and practically of the amount of Montana tax paid. Thus, this feature of the legislation likely would be of little help to Montana REIT shareholders.

Any Legislative Limitations on the Dividend Paid Deductions Should Be Narrowly Drafted. We recognize Montana's interest in adopting legislation that would limit inappropriate uses of REITs such as "captive REIT" structures that have been publicized recently, by denying the DPD in certain limited cases. Two years ago, it was suggested to the Department of Revenue that any limitation to the DPD be limited to REITs that were formed primarily for state tax avoidance. NAREIT remains committed to providing assistance in drafting such legislation.

Accordingly, NAREIT urges you not to enact S.B. 120. Thank you again for the opportunity to submit this testimony.